D. UPDATE ON OBRA '93

by

Theodore Lieber and David Jones

1. Introduction

The Omnibus Budget Reconciliation Act of 1993, P.L. 103-66 (OBRA '93), signed into law on August 10, 1993, contained several provisions affecting exempt organizations. Two major provisions, the disallowance of a deduction under IRC 162 for lobbying expenses, and the substantiation and disclosure provisions, are discussed in separate articles. This article will discuss the impact of some of the other new provisions passed by OBRA '93.

2. Repeal of the Alternative Minimum Tax (AMT) Treatment of Contributions of Capital Gain Property

Section 13171(a) of OBRA repealed IRC 57(a)(6) to eliminate the treatment of contributions of appreciated property (real, personal, and intangible) as a tax preference for purposes of the alternative minimum tax (AMT). Repeal of this AMT provision, which was enacted by the Tax Reform Act of 1986, was sought by many public charities, as they considered the AMT to be a serious barrier to obtaining the support they needed to carry out their exempt functions. So eager were they for AMT relief that the new substantiation and disclosure provisions can be seen as the price charities were willing to pay to obtain it.

Under IRC 170, donors are generally allowed to deduct the fair market value of property contributed to a charitable organization. However, IRC 170(e)(1)(B)(i) limits the deduction to the adjusted basis in the property if the contribution is used by the recipient public charity in a way inconsistent with its exempt purpose. This limit created an incentive for donors to contribute property that could be used in furtherance of a public charity's exempt function. For example, an owner of a work of art that had appreciated in value could donate the work to a public charity art museum and claim a deduction for the fair market value.

Former IRC 57(a)(6) severely limited the benefit IRC 170 otherwise provided to most donors who contributed appreciated property, however, because the donors most likely to contribute appreciated property, such as a valuable painting, were also those likely to be subject to the AMT. This adversely affected public charities that solicit gifts of appreciated property for use in their exempt functions (for example, art museums that seek artworks for their collections).

The effective date of the repeal is important. It is June 30, 1992, for gifts of tangible personal property; December 31, 1992, for other capital gain property.

3. Denial of Deduction for Club Dues

OBRA '93, added IRC 274(a)(3), which disallows a deduction for dues paid to any club organized for business, pleasure, recreation or other social purpose. It justified the change by stating that "it [was] inappropriate to permit a deduction for club dues, where there is an element of personal pleasure and enjoyment. Enacting a strict nondeductibility rule will be easier to administer than determining whether the taxpayer's primary use of club is personal in nature." H.R. Rep. No. 103-213, 103rd Cong., 1st Sess. 583 (1993).

Although the primary thrust of IRC 274(a)(3) is to deny a deduction for club dues paid to a IRC 501(c)(7) social club, it can be applied to all clubs. See H.R. Rep. No. 103-111 103rd Cong. 1st. Sess., 646 (1993); H.R. Rep. No. 103-213, 103rd Cong., 1st Sess 583 (1993). A Senate amendment, followed by the Conference, denied the deduction for membership in airline and hotel clubs.

Social welfare organizations described in IRC 501(c)(4) and social clubs described in IRC 501(c)(7) receive a portion of their support from membership dues. Many corporations pay the yearly dues for their employees' membership in country clubs and social welfare organizations, such as Kiwanis. Prior to OBRA 93, the business payor of the dues was entitled to a deduction under IRC 274(a) if the deduction was primarily for the furtherance of the taxpayer's trade or business and the expense was directly related to the taxpayer's trade or business. No deduction was allowed for an initiation or similar fee payable only upon joining a club if the useful life of the fee was more than one year. In this case the fee was nondeductible as a capital expenditure.

Community service clubs, such as Kiwanis, are arguing IRC 274(a)(3) should not apply to IRC 501(c)(4) organizations, because social welfare organizations provide services to their communities and do not provide any type of personal services or benefits to their members as does a country club. Denver Kiwanis Club President Asks Treasury to Exclude Service Club Dues from Deduction Limitation, 9 EOTR 969 (1994).

Treasury's response to letters submitted by IRC 501(c)(4) organizations is that regulations are being worked on relating to this issue, and that they will take the social welfare organizations concerns into account. See letter written to Senator Dirk Kempthorne from Michael B. Levy, Assistant Secretary of Treasury for Legislative Affairs, Tax Notes Microfiche 94-3266.

4. Title Holding Companies

An important change for IRC 501(c)(2) and IRC 501(c)(25) title holding companies is that they can now receive up to 10 percent of gross income from incidental unrelated trade or business without affecting exempt status.

Exemption of title holding companies described in IRC 501(c)(2) and IRC 501(c)(25) is based upon the organization holding title to real property and collecting income from it. Examples of investments held by title holding companies include shopping centers, office buildings, and apartment buildings. These types of investments generate rental income, which will not be considered unrelated business income.

Service position has been that title holding companies will lose their exemption if they generate unrelated business income from activities other than collecting income from property it holds and remitting it to an exempt parent beneficiaries. Reg. 1.501(c)(2)-1; Notice 88-121, 1988-2 C.B. 457. Title holding companies holding title to shopping centers, office buildings and apartment buildings that provide vending machines for the use of customers and tenants generate unrelated business income from these vending machines, and jeopardize their exemption. H.R. Rept. No. 103-111, 103rd Cong., 1st Sess 618 (1993).

OBRA 93 amended IRC 501(c)(2) and IRC 501(c)(25) through the enactment of IRC 501(c)(25)(G). IRC 501(c)(25)(G) allows IRC 501(c)(2) and IRC 501(c)(25) organizations to receive unrelated business income of up to 10 percent of its gross income, provided that the unrelated business income is incidentally derived from the holding of real property. The reason that IRC 501(c)(25)(G) was enacted was that Congress believes revocation is a harsh solution for an IRC 501(c)(2) or an IRC 501(c)(25) organization receiving small amounts of unrelated business income that is incidentally derived from holding real property. H.R. Rept. No. 103-111, 103rd Cong., 1st Sess 619 (1993).

Examples of incidentally derived income are parking revenue and income from vending machines. Manufacturing would not be considered incidental to the holding of real property. H.R. Rept. No. 103-111, 103rd Cong., 1st Sess 619 (1993). This provision is not an exclusion from unrelated business income for title holding companies, but is a test in determining whether exemption will be jeopardized. Title holding companies receiving incidentally derived unrelated business income will pay unrelated business income tax on that income. A title holding company incidentally deriving income of more than ten percent from real property will not jeopardize exemption provided it establishes to the satisfaction of the Secretary of the Treasury that the excess UBI was inadvertent and reasonable steps are being taken to correct the circumstances to correct the circumstances giving rise to the excess unrelated business income. H.R. Rept. No. 103-111, 103rd Cong., 1st Sess. 619 (1993).

5. <u>Unrelated Business Income Tax Provisions</u>

A. <u>IRC 512(b)(16) - Exception to IRC 512(b)(5)</u>

New IRC 512(b)(16) provides an exception from the definition of unrelated business income for sales of certain property acquired in Resolution Trust Corporation (RTC) foreclosure sales.

Before OBRA '93, an exempt organization that sold several parcels of real property might have been subject to tax under IRC 512(b)(5). IRC 512(b)(5) excludes from unrelated business income all gains and losses from the sale of property, but includes as unrelated business income gains and losses from the sale, exchange or other disposition of property that would be considered "inventory" or property held primarily for sale to customers in the ordinary course of business. Congress was concerned that the section's broad scope would include situations where exempt organizations purchased real estate for investment at RTC foreclosures. It was concerned that exempt organizations making these investments might be considered dealers of property.

To permit exempt organizations a freer hand to invest in real estate purchased from troubled financial institutions, section 14147 of OBRA added IRC 512(b)(16), a narrow exception to the dealer inventory rule of IRC 512(b)(5)(B). Where IRC 512(b)(5) applies to all types of property, IRC 512(b)(16) excludes gains and losses from the sale of certain real property and mortgages acquired from a financial institution that is in conservatorship or receivership from unrelated business income. Only property that was held, or was security for a loan held, at the time the financial institution went into receivership is subject to the exception.

IRC 512(b)(16) focuses on the previous holder of the real property. IRC 512(b)(16)(A)(i) provides that the property must have been acquired from a financial institution in conservatorship or receivership or acquired from the conservator or receiver of a financial institution (or any governmental agency or corporation succeeding to the rights or interests of the conservator or receiver).

After acquiring the property, IRC 512(b)(16)(A)(ii) provides that the organization needs to designate the real property within 9 months of the date of acquisition. Property designated as held for sale would then not be subject to unrelated business income. However, no more than one half of the property acquired in a single transaction may be designated as property held for sale.

IRC 512(b)(16) also requires the acquiring exempt organization to dispose of the real property within a certain time after acquisition. IRC 512(b)(16)(A)(iii) provides that the property must be disposed of within two and one half years after acquisition or a date specified by the Secretary in order to assure an orderly disposition.

A cap on the amount of improvements before resale is also provided for in IRC 512(b)(16). IRC 512(b)(16)(A)(iv) provides that improvements to the property's basis should not exceed 20 percent of the net selling price of the property.

B. IRC 512(b)(5)-Exclusion of Certain Option Premiums and Loan Commitment Fees from UBTI

OBRA section 13418(b) expanded IRC 512(b)(5) to exclude gains on the lapse or termination of options on real property, and from the forfeiture of loan commitment fees for the purchase, sale, or lease of real property from unrelated business income. Thus all unexercised options on securities and real estate are excluded from unrelated business income.

Before OBRA '93, IRC 512(b)(5) provided an exclusion from unrelated business income for gains on the lapse or termination of options on securities, written by an organization in connection with its investment activities. It was unclear whether premiums from unexercised options on real estate or loan commitment fees are unrelated business income. Loan commitment fees are nonrefundable charges made by a lender to reserve a sum of money with fixed terms for a specified period of time. H.R. Rept. No. 103-111, 103rd Cong., 1st

Sess 620 (1993). The loan commitment fees are to compensate the lender for the risk inherent in committing to make the loan (e.g. for the lender's exposure to interest rate charges and for potential lost opportunities).

The legislative history to OBRA explains that IRC 512(b)(5) was changed because gains and losses from options should be treated consistently for purposes of determining unrelated business income. H.R. Rept. No. 103-111, 103rd Cong., 620 (1993). Furthermore, taxing loan commitment fees and premiums from unexercised options on real estate is inconsistent with the generally tax-free treatment of income from investment activities accorded to exempt organizations.

C. IRC 514

OBRA 93 enacted IRC 514(c)(9)(G) and (H), which relax the requirements of IRC 514(c)(9)(B) for determining whether a qualified organization has acquisition indebtedness on property. The effect is to lessen the chance that property will be considered "debt financed" and therefore subject to unrelated business income tax.

IRC 514 provides that organizations will have "unrelated business income" from debt financed property if property was acquired with borrowed funds and it generates income. The organization will have unrelated business income in proportion to the amount of debt on the property. In calculating debt financed income, organizations must determine acquisition indebtedness as defined in IRC 514(c), and determine whether the property is debt financed as defined in IRC 514(b).

Pension trusts, educational institutions under IRC 170(b)(1)(A)(ii) and their affiliated section 509(a)(3) supporting organizations, and section 501(c)(25) organizations will not have an acquisition indebtedness if debt is incurred due to the acquisition or improvement of real property. The following six restrictions stated in IRC 514(c)(9)(B)(i)-(vi) must be satisfied for the qualified organization not to have an acquisition indebtedness:

(1) The purchase price of the real property is a fixed amount determined as of the date of acquisition (fixed price restriction);

(2) The amount of the indebtedness or any amounts payable with respect to the indebtedness, or the time for making any

payment of any such amount, is not dependent upon revenues, income or profits derived from the property (the participating loan restriction);

(3) The property is not leased by the qualified organization to the seller or to a person related to the seller (the leaseback restriction);

(4) In the case of a pension trust, the seller or lessee of the property is not a disqualified person (the disqualified person restriction);

(5) the seller or person related to the seller is not providing financing in connection with the acquisition of the property (the seller financing restriction);

(6) if the investment in the property is held through a partnership, certain additional requirements are satisfied by the partnership (the partnership restrictions).

New IRC 514(c)(9)(G) and (H) relax the requirements of IRC 514(c)(9)(B). IRC 514(c)(9)(G)(i) relaxes the leaseback and disqualified person provisions of IRC 514(c)(9)(B)(iii) and (iv). IRC 514(c)(9)(G)(i) permits an organization to leaseback debt financed property to the seller or disqualified person, where no more than 25 percent of the leasable floor space is leased back, and the lease is on commercially reasonable terms, independent of the sale and other transactions.

IRC 514(c)(9)(G)(ii) eases the seller financing restriction provided in IRC 514(c)(9)(B)(v). IRC 514(c)(9)(G)(ii) permits a seller, a person related to the seller, or a disqualified person to provide financing to the qualified organization where the financing is on commercially reasonable terms independent of the sale and other transactions.

IRC 514(c)(9)(H) relaxes the fixed price restriction and participating loan restriction provided in sections 514(c)(9)(B)(i) and (ii) of the Code. IRC 514(c)(9)(H) provides that the property purchased by the organization must be purchased at a qualifying sale. IRC 514(c)(9)(H)(ii) defines a qualifying sale as:

(1) an organization acquiring the property must acquire it from a financial institution, and any gain recognized by the financial institution with respect to the property is ordinary income; the

type of property must have been acquired by the financial institution by foreclosure, or was held by the selling financial institution at the time it entered into conservatorship or receivership;

(2) the stated principal amount of the seller financing does not exceed the financial institution's outstanding indebtedness with respect to the property at the time of foreclosure or default; and

(3) the present value of the maximum amount payable pursuant to the financing determined by reference to the revenue, income or profits derived from the property cannot exceed 30 percent of the total purchase price of the property.

D. Repeal of Automatic UBTI Rule for Publicly Traded Partnerships

Section 13145(a)(1) of OBRA repealed IRC 512(c)(2) to make it easier for exempt organizations to invest in publicly traded partnerships.

Generally, partnerships are not subject to tax at the partnership level, but are taxed at the partner level. However, if the partnership is publicly traded, it will be subject to IRC 7704(a), which treats a publicly traded partnership as a corporation. An exception to IRC 7704 provides that a partnership deriving 90% or more of their gross income from passive type income, such as dividends, interest, real property, and certain capital gains income will not be treated as a corporation.

Under IRC 7704, an exempt organization that is a partner in a publicly traded partnership that generates more than 90% of its income from passive sources would be treated as receiving partnership income rather than a dividend from a corporation. Prior to 1987, the income generated from the publicly traded partnership would only be taxed at the partner level, and would escape tax with an exempt partner due to the modifications of IRC 512(b). Thus a partner in a publicly traded partnership would be taxed the same as a partner receiving a distributive share in a partnership.

To prevent passive income generated from a publicly traded partnership from escaping taxation, Congress passed IRC 512(c)(2) through the OBRA '87 legislation. IRC 512(c)(2) taxes all income from a publicly traded partnership as unrelated business income. Section 512(c)(2) did not take into account whether the underlying character of the income was related or unrelated.

IRC 512(c)(2) deterred exempt organizations from investing in publicly traded partnerships. Passive income that was not subject to unrelated business income when received from a non-publicly traded partnership was unrelated business income when received from a publicly traded partnership. IRC 512(c)(2) was repealed by Congress through section 13145(a)(1) of OBRA, because they believed that exempt organizations could provide a valuable source of capital that should be available to publicly traded partnerships. H.R. Rept. No. 103-111, 103rd Cong., 1st Sess. 617 (1993). With the repeal of IRC 512(c)(2) by OBRA '93, exempt organization's investments in publicly traded partnerships and partnerships will be treated the same for purposes of determining unrelated business income.

6. Further Guidance

The Service and Treasury at this point in time do not plan on providing any guidance concerning the above amendments except for regulations relating to IRC 274(a)(3).